Supreme Court, U.S.
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No. 07-684

IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF

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CORPORATE DISCLOSURE STATEMENT

Petitioner's Corporate Disclosure Statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that Statement.

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PRELIMINARY STATEMENT

The Opposition is a testament to why *certiorari* should be granted in this case. Only by reframing the "Question Presented" can ET Power argue that this case involves a garden-variety application of Bankruptcy Code § 502(b)(2) unworthy of this Court's consideration. This difference in framing the "Question Presented" is fundamental. ET Power tries to divert attention from the underlying question this Court should review: whether judicial recharacterization of Liberty's valid state law claim can defeat Liberty's recovery in bankruptcy for the remaining principal due and owing after allocating interest previously paid by a non-debtor guarantor?

The Fourth Circuit refused to adhere to state law in disallowing Liberty's claim. Neither the Opposition nor the decision below disputes that Liberty has a valid state law claim for *principal* because it is entitled to: (i) allocate its recovery from GTN first to interest, (ii) apply the remaining GTN recovery to principal, and then (iii) enforce its remaining principal claim against ET Power. *See* App. 11a n.5, 13a. To address what it perceived as inequity, the Fourth Circuit *sua sponte* invoked "broad equity powers" to "recharacterize" Liberty's claim as *interest*, even though under state law, it is actually *principal*. Only because of this *recharacterization* could it then invoke section 502(b)(2) to disallow Liberty's claim as unmatured interest.[1]

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[1] As Justice Frankfurter noted, "Putting the wrong questions is not likely to beget right answers even in law." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 170 (1946) (concurring opinion).

The fundamental flaw in this reasoning is that the Fourth Circuit lacked authority to recharacterize Liberty's claim in the first place. The Bankruptcy Code provides no such authority, in section 502 or otherwise. Neither the decision below nor the Opposition points to *any* Bankruptcy Code section authorizing "equitable recharacterization" of a claim for principal.

The Fourth Circuit's disallowance of Liberty's principal claim in the absence of inequitable conduct violates section 510(c). Despite ET Power's protestations that section 510(c) is irrelevant because the majority opinion did not mention it, section 510(c) is the Code's only provision wherein Congress permitted resort to "equitable principles" to impact creditors' claims.[2] And it only authorizes *subordination*, not *disallowance*.

ET Power's argument that no circuit split exists relating to the post-petition interest exception in section 502(b)(2) misses the point – the relevant issue concerns the resort to "equity" to disallow valid state law claims, in violation of sections 502(b) and 510(c). Moreover, the ruling below is at odds with other circuits' rulings applying both sections 502(b)(2) and 510(c). The circuits disagree about the scope of bankruptcy court authority to use "equitable principles" to disallow claims that are – in this case, concededly – valid under state law. All six circuits addressing the issue – *other than the decision below* – require proof of inequitable conduct to trigger equitable subordination or disallowance of otherwise valid claims. Five of the six permit either disallowance

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[2] That the Fourth Circuit ignored section 510(c) underscores the need for this Court's review.

or subordination; the Fifth Circuit permits only subordination. In conflict with six other circuits, the Fourth Circuit disregarded the predicate requirement of inequitable conduct: it *disallowed* a claim based on what it perceived to be inequity, *without any evidence or findings of fact* to support this conclusion, and contrary to the actual findings of the bankruptcy court. This case presents an issue similar to that expressly reserved in *United States v. Noland*, 517 U.S. 535, 543 (1996): "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated."

The decision below suffers from the same analytical flaw as that addressed in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, 127 S. Ct. 1199 (2007) – federal courts enlisting "equity" to disallow otherwise valid and enforceable claims, in contravention of state law and untethered to any statutory authorization in the Bankruptcy Code. The clear-cut circuit split here requires *certiorari* review to resolve fundamental questions of claims allowance in bankruptcy and to prevent the further development of yet another *Fobian*-like judge-made rule of claim disallowance in bankruptcy.

RESPONDENTS' OPPOSITION IS UNFOUNDED

I. The Decision Below Conflicts With This Court's Precedents Governing The Interplay Between State Law And Bankruptcy Claims Allowance.

The threshold question for allowability is whether Liberty's contract claim is valid and enforceable under applicable state law. *See Travelers*, 127 S. Ct. at 1206 ("claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed"); *Raleigh v. Ill. Dept. of Revenue*, 530 U.S. 15, 20 (2000) ("The 'basic federal rule' in bankruptcy is that state law governs the substance of claims") (quoting *Butner v. United States*, 440 U.S. 48, 57 (1979)).

Under state law, Liberty's claim is unquestionably for principal. A claim for principal is not disallowed by section 502(b)(2). Although conceding Liberty's entitlement under state law to allocate recoveries first to interest, the Opposition seeks to extend section 502(b)(2) to prohibit Liberty's collection of post-petition interest from its non-debtor guarantor, GTN.[3] This argument fails, given the bankruptcy court's undisturbed findings that "[t]he payment of interest by GTN does not diminish this estate," and Liberty's allocation of the GTN funds to interest first was "commercially reasonable". App. 36a, 37a. This case is not about Liberty unfairly "characterizing" its unpaid claim as one for principal. Rather, it is about the Fourth Circuit's

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[3] By extending the "unmatured interest" bar to non-debtor guarantors the Opposition also violates Bankruptcy Code § 524(e), which preserves creditors' rights against non-debtors.

decision, for largely unarticulated reasons, to disallow a principal claim as if it were an interest claim in the face of established facts and law to the contrary.

The Fourth Circuit maintained it did not impair Liberty's valid claims and state law rights, offhandedly suggesting that "Liberty is free to . . . pursue collection from GTN at any time." App. 11a n.5. But Liberty had already collected what it could from GTN; the Fourth Circuit merely gave lip service to Liberty's freedom under state law to collect and allocate payments from GTN, as shown by its ruling "that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor." *Id.* This ruling disregarded state law (and created a new bankruptcy rule), overturning Liberty's payment allocation because the Fourth Circuit erroneously concluded ET Power's estate would benefit from a different allocation outcome.[4]

The Fourth Circuit's invocation of vague, equitable powers to override state law contract claims is the same kind of judge-made rule the Ninth Circuit used in *Fobian v. Western Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991). The *Fobian* rule barred allowance

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[4] Under any scenario, ET Power will make the same bankruptcy distribution on the $140 million principal claim as it makes on other claims. If Liberty is entitled to a distribution of $17 million of principal on its $140 million claim (GTN already paid $123 million), then GTN may assert as a subrogation claim the portion of the $140 million claim yielding Liberty more than $17 million. If Liberty cannot assert any claim against ET Power (on the theory that GTN paid $140 million in principal), then GTN can assert a $140 million claim against ET Power. Either way, ET Power makes the same aggregate distribution on a principal claim of $140 million.

of attorneys' fees relating to litigation of bankruptcy law issues, despite contractual provisions authorizing such claims. In *Travelers*, this Court firmly rejected such free-floating equity analyses that would disallow otherwise valid contract claims:

> The *Fobian* rule finds no support in the Bankruptcy Code, either in § 502 or elsewhere. In *Fobian*, the court did not identify any provision of the Bankruptcy Code as providing support for the new rule. See 951 F.2d, at 1153. Instead, the court cited three of its own prior decisions [citations omitted]. Significantly, in none of those cases did the court identify any basis for disallowing a contractual claim for attorney's fees incurred litigating issues of federal bankruptcy law.

Travelers, 127 S. Ct. at 1205. The ruling below suffers the same fatal defects.

II. Review Is Warranted To Address Conflict Among The Courts Of Appeals Regarding The Use Of Equitable Principles To Disallow Claims In Bankruptcy.

By assuming that broad equitable disallowance powers are somehow embedded in section 502, and by rephrasing the question presented here, the Opposition denies the existence of a split of authority among the circuits. According to ET Power, no conflict exists regarding section 502(b)(2)'s application to disallow an "unmatured interest" claim. But the improper recharacterization of Liberty's principal claim as interest

was the necessary predicate to its disallowance. Whether "equitable principles" allow federal courts in bankruptcy cases to recharacterize and disallow valid state law claims – authority that is not codified in section 502 – is undeniably the subject of an entrenched circuit split arising from application of section 510(c). As the codification of equitable disallowance and subordination case law under the former Bankruptcy Act,[5] section 510 is the only Bankruptcy Code section that expressly permits equitable principles to alter a bankruptcy creditor's otherwise valid and enforceable state law claim.

The Petition demonstrates a three-way split of authority among the circuits. The Sixth, Seventh, Eighth, Ninth and Tenth Circuits permit either equitable subordination or the complete disallowance of claims in bankruptcy pursuant to section 510(c), but only based upon a finding of misconduct. *See* cases collected at Pet. 14-15. No such "inequity" has been alleged here, much less proven. On the contrary, the bankruptcy court found that collecting interest first from GTN was commercially reasonable and did not adversely impact the estate. App. 36a, 37a. The Fifth Circuit takes a different approach, holding that inequitable conduct justifies equitable subordination under section 510(c), but not disallowance. *See* Pet. 13. The Fourth Circuit's ruling in this case has created the three-way split, holding that claims may be equitably disallowed *without any proof of inequitable conduct.* In so ruling, the Fourth Circuit contradicted its earlier decision requiring proof

[5] *See* 4 COLLIER ON BANKRUPTCY ¶ 510.LH (Alan N. Resnick & Henry J. Sommer eds., 15th ed., rev. 2007).

of misconduct as a predicate to equitable subordination of a claim. Pet. 14.

Whatever equitable powers bankruptcy courts have, they are not limitless, and must only be exercised within the statutory framework of the Bankruptcy Code. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). Here, without authority under the Bankruptcy Code (indeed, in conflict with section 510(c)), the Fourth Circuit invoked equity to recharacterize and disallow Liberty's claim, thereby exacerbating an already existing split of circuit authority.

III. The Opposition's Authorities Regarding Section 502(b)(2) Actually Conflict With The Ruling Below.

With one negligible exception, none of the cases cited in the Opposition support the proposition that Liberty's claim constitutes unmatured interest that should be disallowed pursuant to section 502(b)(2). As ET Power admits, virtually *all* of the cases it cites actually "reached a different conclusion from that of the majority below." Opp. 18. Inadvertently, the Opposition establishes that the ruling below conflicts with Supreme Court and circuit authority on this very issue.

The Opposition showcases *Thrifty Oil Co. v. Bank of America National Trust & Savings Ass'n*, 322 F.3d 1039, 1047-48 (9th Cir. 2003), and the cases it cites. Opp. 15-19. Ironically, *Thrifty* was later overruled in part by *Travelers* because it applied the *Fobian* rule in disallowing attorneys' fees. *Travelers*, 127 S. Ct. at 1206-07. In *Thrifty*, the debtor contended that the

periodic payments and termination fees payable under its interest rate swap agreements with its lender constituted "unmatured interest." The *Thrifty* court rejected this argument. *Thrifty*, 322 F.3d at 1043, 1048-50.

Similar results obtained in the cases cited in *Thrifty*: the challenged claims were *not* disallowed as "unmatured interest." *See, e.g., LTV Corp. v. Valley Fid. Bank & Trust Co. (In re Chateaugay Corp.)*, 961 F.2d 378, 382 (2d Cir. 1992) (face value exchange of debt in consensual workout did not create "unmatured interest" in form of "original issue discount," so claims not disallowed); *Tex. Commerce Bank, N.A. v. Licht (In re Pengo Indus., Inc.)*, 962 F.2d 543, 549 (5th Cir. 1992) (same); *Mt. Rushmore Hotel Corp. v. Commerce Bank (In re Mt. Rushmore Hotel Corp.)*, 146 B.R. 33, 37 (Bankr. D. Kan. 1992) (discounted market price paid by bondholders did not constitute "unmatured interest"); *In re Skyler Ridge*, 80 B.R. 500, 508 (Bankr. C.D. Cal. 1987) (mortgage prepayment penalties do not constitute "unmatured interest" even though they protect realization of the contractual interest rate).

Nor does *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946),[6] support ET Power's argument. *Vanston* disallowed a fully secured creditor's claim against the estate for post-petition "interest on interest" (although allowing simple post-petition interest). After acknowledging that the claim was invalid in the first place under New York law, the Court reasoned that, even if valid under state law, interest-on-interest

[6] Opp. 16, 17, 24 and 27-29.

should not be allowed in that case because it would penalize the estate for not making simple interest payments the court suspended while it administered the case. *Id.* at 165-167. *Vanston's* rationale is inapplicable here: Liberty's claim is for principal only, and no similar "penalty" exists for making distributions of principal for which ET Power was indisputably liable.

Vanston does not in any way address nor restrict enforcement of post-petition interest *against parties other than the bankruptcy estate. Bruning v. United States*, 376 U.S. 358 (1964),[7] squarely addresses this issue, holding that post-petition interest could be enforced against an individual debtor who was not discharged of tax liabilities:

> The basic reasons for the rule denying postpetition interest as a claim against the bankruptcy estate are the avoidance of unfairness as between competing creditors and the avoidance of administrative inconvenience. These reasons are inapplicable to an action brought against the debtor personally.

Bruning, 376 U.S. at 362-63. *Accord Hanna v. United States (In re Hanna)*, 872 F.2d 829, 830-31 (8th Cir. 1989) (section 502(b)(2) only bars post-petition interest "against the bankruptcy estate;" post-petition interest is nondischargeable *and enforceable* against individual debtors who remain personally liable). For the same reason, enforcing a claim for post-petition interest

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[7] Opp. 18, 24 and 27.

against a non-debtor, third-party guarantor does not implicate section 502(b)(2). The very purpose of a guarantee is to collect amounts, such as unmatured interest, that are not allowable against a debtor. *See In re El Paso Ref., Inc.*, 192 B.R. 144, 146 (Bankr. W.D. Tex. 1996) (section 502(b)(2) bars unmatured interest claims against the estate, not against a guarantor); *Stoller's, Inc. v. Peoples Trust Bank (In re Stoller's, Inc.)*, 93 B.R. 628, 635-36 (Bankr. N.D. Ind. 1988) (same).

Similarly inapposite are most of ET Power's other authorities. They neither involved recharacterization of a claim for principal into an unmatured interest claim, nor the right to recover interest from sources other than the estate. *See, e.g., In re Fesco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993) (rejecting creditors' request to override section 502(b)(2) and collect concededly unmatured interest on belatedly allowed claims to compensate for distribution delay); *Brown v. Sayyah (In re ICH Corp.)*, 230 B.R. 88, 96 (N.D. Tex. 1999) (remanding for trial on the factual issue of whether a transaction involved "original issue discount"); *United States v. Energy Res. Co.*, 495 U.S. 545, 551 (1990) (upholding debtor's right to direct the Internal Revenue Service to apply its tax payments first to extinguish trust fund obligations under a reorganization plan).

Only one case cited by ET Power held (without any substantive analysis and without citing or considering *Bruning*) that post-petition interest could not be collected from a non-debtor guarantor. Opp. 19-20. In *Aetna Business Credit, Inc. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 7 B.R. 465, 469 (Bankr. D.

Minn. 1980), a decision not followed anywhere, the court reasoned that the guarantor was liable only for what the debtor owed, but inexplicably erred in concluding the debtor did not owe post-petition interest, whereas in fact the debtor *owed* the interest. Section 502(b)(2) merely prevented its allowance against the debtor's estate.

Ignoring this Court's ruling in *Bruning* and other authorities holding that section 502(b)(2) does not bar collection of post-petition interest from non-estate sources, ET Power suggests this Court should instead consider case law construing section 502(b)(6), which caps claims for lease "rejection" damages, such as *Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.)*, 324 F.3d 197, 210 (3d Cir. 2003). Opp. 21-23. The distinctly different legislative histories and purposes of section 502(b)(2)'s bar on unmatured interest claims versus section 502(b)(6)'s landlord "cap" make the latter a very poor analogy. Moreover, contrary to the debtors' insinuation, *PPI* does not limit recovery against third parties. Rather, the decision emphasizes that, according to the lease terms at issue, the letter of credit and proceeds thereof constituted a security deposit, and therefore qualified as estate property to which the cap applied.[8]

ET Power's own authorities demonstrate that the Fourth Circuit's decision has created a conflict with this

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[8] Notably, the circuits are split on the treatment of letter of credit proceeds. *Compare PPI with EOP-Colonnade of Dallas Ltd. P'ship v. Dennis Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 269-70 (5th Cir. 2005) (cap applies only to claim against estate, and does not limit recourse to letter of credit proceeds).

Court's precedents and decisions from other circuits, and certiorari is warranted.

IV. This Case Presents An Issue Of Vital Importance On A Fundamental Proposition Of Bankruptcy Law.

Whether federal courts can resort to general principles of equity to eliminate allocation rights under guarantees and recoveries on valid state law claims in bankruptcy is a question implicated in "mega" cases under chapter 11, as well as individual cases under chapters 7 and 13. The division among the Courts of Appeals is real and pervasive, and is not likely to resolve itself absent this Court's intervention.

CONCLUSION

For the foregoing reasons, Liberty respectfully requests that this Court grant the Petition.

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